



Asset Exchange Company

1031



1031 Exchange Strategies for Tax Deferral

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Principal

Asset Exchange Company

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Member of the Federation of Exchange Accommodators



Bank with Union Bank of California



Errors and Omissions Insurance and Fidelity Bond through Lockton Insurance Brokers

Department of Consumer Affairs
California Board of Accountancy

Member of the CA Board of Accountancy



Member of the State Bar of California

Asset Exchange Company

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Galaxy Office Park, Concord CA

- \$42,000,000 Sale Price
- 3 LLC owners, with multiple LLC members
- \$11MM in unsecured debt
- Buyers and sellers decided to prorate the sales price in different manners between 3 parcels



Sandy Springs Apartments, Atlanta GA

- \$26,000,000 Sale Price
- 27 individual TIC owners
- Each individual owner conducting separate exchange



Brittan Ave Condo, San Carlos CA

- \$617,000 Sale Price
- 2 owners
- One owner conducting an exchange

The Tax Code

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IRC Section 1031?

- Investment Real Estate
- Tax Deferral

IRC Section 121?

- Primary Residence
- Tax Avoidance
 - \$250K single
 - \$500K married

Why 1031 Matters...

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Why does the Realtor care?

- Earn two commissions from one sale.
- Seller of clients replacement property may be unaware of exchange benefits.
- Larger properties = Larger commissions.
- Become the local exchange expert.
- Great prospecting tool for new and veteran agents.
 - Approach investors with ways to improve their position in the real estate market.

Why Exchange?

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Why Investors Exchange:

Tax Deferment

- 15% Federal Capital Gain Tax for assets held > 1 year.
- 9.3% State Capital Gain Tax.
- 25% Depreciation Recapture Tax.

Buy "MORE" Property

- Utilize "saved/deferred taxes" to leverage into a larger property.
- Exchange from a property that has a high equity position into a much more valuable property.

Diversification

- Geographic diversification.
- Asset class diversification.

Longtime Ownership Issues

- Relief of management burden.
- Exchange from a fully depreciated property to a higher value property that can be depreciated.

Gain Calculation

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Gain Calculation:

Sale Price	\$1,000,000
(Adjusted Basis)	(\$425,000)
<u>Gain</u>	<u>\$575,000</u>

Adjusted Basis

Purchase Price	\$500,000
(Depreciation)	\$100,000
+Capital Improvements	\$25,000
<u>Adjusted Basis</u>	<u>\$425,000</u>

Facts:

\$500,000 purchase price
\$100,000 depreciation
\$25,000 capital improvements
\$1,000,000 sales price

Taxes:

25% Dep. Recapture

$$\$100,000 \times 25\% = \$25,000$$

15% Fed. Cap Gains

$$\$475,000 \times 15\% = \$71,250$$

9.3% State Cap Gains

$$\$575,000 \times 9.3\% = \$53,475$$

Total Taxes Due: \$149,725

Recently from the IRS

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Vacation Homes:

- **14 days (minimum) of rent required**
- **Owner can not use the vacation home for more than 14 days or 10% of the time the home is rented.**

Example:

- **Tahoe property rented for 270 days can be used by owner for 27 days maximum and still qualify for an exchange.**

1031 Guidelines

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Basic Requirements

- Property Qualifications
- Tax Deferral Requirements
- Timeline
- Identification Rules

Guideline #1

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➤ **Property Qualifications**

- Held for productive use in trade or business or for investment.
- Like kind
 - Foreign property is NOT like kind

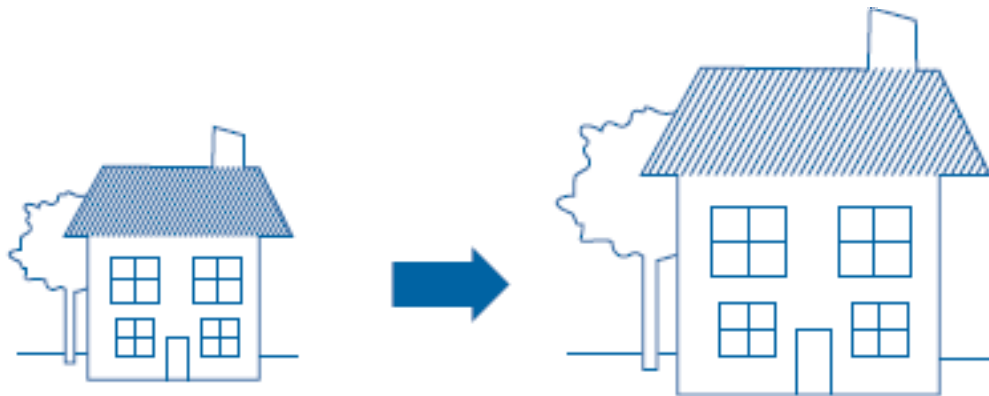


Guideline #2

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➤ Tax Deferral Requirements

- Reinvest all cash.
- Purchase price equal to or greater than replacement property sale value.

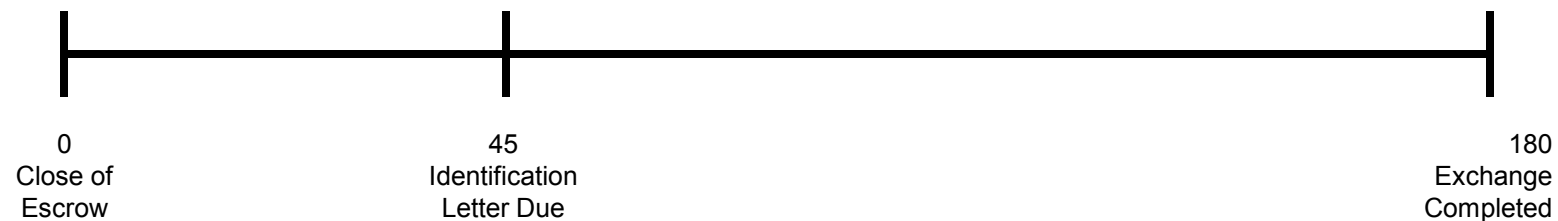


Guideline #3

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➤ **Timeline**

- 180 days - or until your taxes are due for the year
- 45 day identification period.
- COE after October 17th must file extension.



Guideline #4

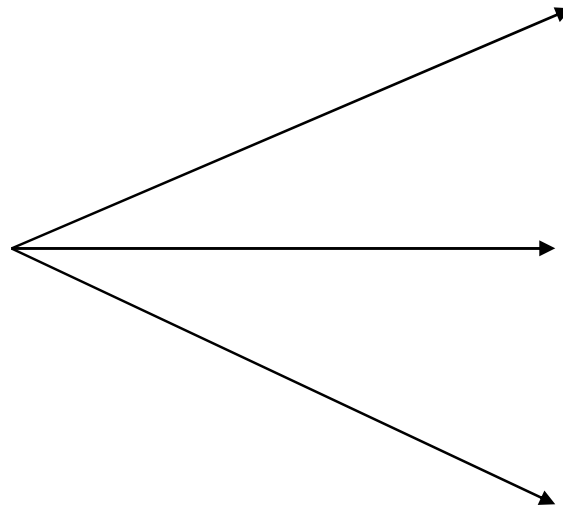
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- **Identification**
 - 3 Property Rule
 - 200% Rule

Guideline #4

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➤ 3 Property Rule



Guideline #4

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➤ 200% Property Rule



200%

Agent's Responsibility

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Responsibilities of the Agent

- **Inform your client of the 1031 Exchange**
 - All non-owner occupied listings
 - Any listing that has ever been used as an investment property
- **Insert language into the Purchase and Sale agreement**
 - *Buyer is aware that Seller is to perform an IRC 1031 tax deferred exchange. Seller requests buyers cooperation in such an exchange, and agrees to hold Buyer harmless from any and all claims, liabilities, costs, or delays in time resulting from such an exchange. Buyer agrees to an assignment of this contract to Asset Exchange Company. by the Seller.*
- **Make sure client opens up an Exchange Account**
 - Call Leonard at 877.471.1031
- **Help your client find replacement property**
 - MLS
 - LoopNet.com
 - TIC brokers, etc.

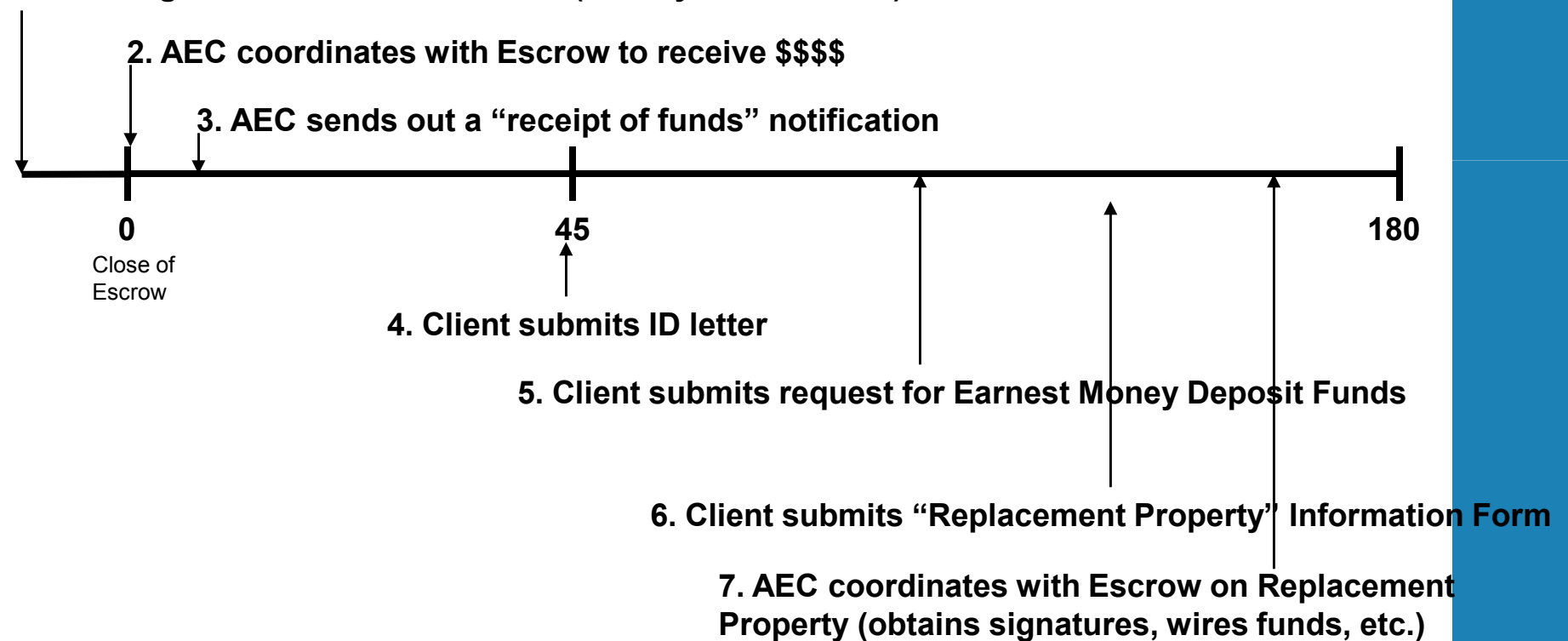


The Process

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The 1031 Exchange Process

1. Exchange Documents are sent out (5-7 days before COE)



Exchange Types

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1031 Exchange Types

- **Simultaneous Exchange**
 - Ownership of both properties transfers concurrently.
 - Very rare.
- **Delayed Exchange**
 - Relinquished property transferred at Time 1, Replacement property acquired at Time 2.
 - Most common type of exchange.
- **Reverse Exchange**
 - Replacement property acquired before original or “relinquished” property is sold.
 - Often used in a “hot market” where.
- **Construction Exchange**
 - Replacement property acquired is for the purpose of new construction.
 - Exchange funds must be used on construction before 180 day timeline is up.

What If...

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What If:

- I've owned a property for 7 months can I exchange it???
- I put \$20,000 down on my property when I first bought it. Can I get that money back when I exchange?
- I sold for \$500K, and am buying for \$500K, but getting a \$20K credit. Will I pay taxes?
- I sold my rental in Texas for \$150K, I'd like to retire and buy \$150K motorhome. Can the motorhome count for a 1031 Exchange?
- I have a cabin in Tahoe. Can I exchange it for a fourplex?

Case Study – Claire in SF

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Facts:

- Claire purchased her Pac Heights home in 1970 for \$400,000.
- Claire would like to downsize and move to a smaller 2,000 square foot property
- Claire's Pac Heights home is now worth \$4,000,000

Problem:

Claire has a taxable gain of approx. \$3,600,000

After Claire's homeowners exemption (\$500K) her tax bill is still approximately \$750,000

Case Study – Claire in SF

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Solution:

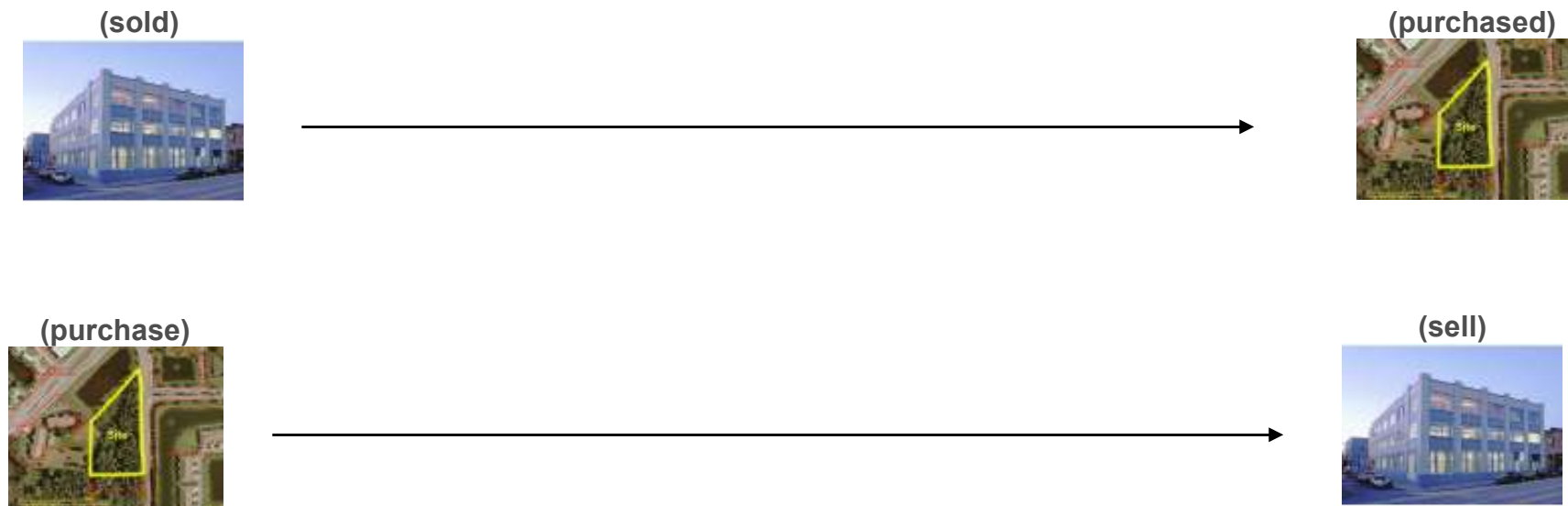
- Combine Homeowners exemption and 1031 Exchange
- Claire postpones the sale of her Pac Heights home
- Claire rents the home out for one year
- Clair sells the property as a rental, pays \$0 in taxes

NOTE:

- Claire must buy \$3,500,000 worth of investment property (\$4,000,000 less \$500k exemption).

Reverse Exchange

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Reverse Exchange

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Why do a Reverse Exchange

- Seize the Moment – the buy of a lifetime
- Insurance Policy – Overheated market, protect your exchange (insurance policy)
- Poor Planning – My property isn't selling when I thought it should and I've already made an offer

Reverse Exchange

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Mechanics of a Reverse Exchange

(purchased)



(sold)



Replacement Property Parked

Considerations:

- Will relinquished property sell within 180 days?
- How will property be financed without proceeds from the sale of the relinquished property?
- Will the lender allow the EAT to take title to the replacement property?

Relinquished Property Parked

Considerations:

- Will relinquished property sell within 180 days?
- How will property be financed without proceeds from the sale of the relinquished property?
- Is there a “due on sale” clause on the debt of the relinquished property?

Construction Exchange

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Construction Exchange

- **Replacement < Relinquished** - The property to be acquired in the exchange is not of equal or greater value to property being sold. In this case, the improvement exchange can eliminate a taxable situation by adding capital improvements to a new replacement property.

- **To build a new investment from ground-up.** This example maximizes the investment opportunity in a given area by enabling an Exchanger to build their own property. You don't have to be subject to property on the market and the seller's terms. Build a new one!

- **Refurbishments are required** - The new investment is of equal or greater value but it needs refurbishments! Utilize the improvement exchange to refurbish the new property while again using tax-free dollars!



Seller Financing

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Seller Financing and 1031 Exchanges:

(1) DO NOT include the Note in the exchange and pay any taxes. The Exchanger would receive the Note as the Beneficiary at the closing and pay taxes on this portion of the capital gain under the Installment method (§453).

(2) Include the Note in the exchange by showing the “Asset Exchange Company” as the Beneficiary and possibly defer the capital gain taxes.

Option #2: Asset Exchange Company as the note beneficiary:

- Use the Note Towards the Down Payment on the Replacement Property
- Exchanger Purchases Note From the Exchange Company
- The Payer on the Note Pays Off the Note Prior to Closing on the Replacement Property
- Sell the Note on the Secondary Market

Cash Out

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Getting Money Out:

- Take money out **BEFORE** it is transferred to Asset Exchange Company (coordinate with Escrow)
- Identify 1 property, close on that property – remainder of funds can be distributed back
- Cancel the exchange within the first 45 days; Asset Exchange Company can distribute funds on day 46
- Cancel the exchange after day 45; Asset Exchange Company can distribute funds on day 180

Penalties

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DOBRICH VS. COMM. (October 20, 1997)

What Happened:

The Dobrich's intentionally "back-dated" an Identification Notice. This was discovered by the IRS and they were *liable for \$2.2 Million in capital gain taxes PLUS a \$1.6 Million fraud penalty!*

Closing Costs

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Costs that can be deducted:

- Any direct cost of selling real property, which typically include:
 - Real estate commissions
 - Title insurance premiums
 - Closing or escrow fees
 - Legal fees
 - Transfer taxes and Notary fees
 - Recording fees - or -
- Costs specifically related to the fact the transaction is an exchange such as the Qualified Intermediary fees.

Costs that can NOT be deducted:

- Mortgage points and
- Assumption fees
- Credit reports
- Lender's title insurance
- Prorated mortgage insurance
- Loan fees and loan
- application fees
- Property taxes
- Utility charges
- Association fees
- Hazard insurance
- Credits for lease deposits
- Prepaid rents and security deposits

Refinancing Issues

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Avoiding a “Step- Transaction”

1. **Separate Purpose** - The refinance loan should not appear to be solely for the purpose of "pulling out equity," thereby avoiding the capital gain tax that is otherwise attributable to non-exchange transactions.
2. **Separate Transaction** - the refinance transaction should be separated from the exchange sale or purchase transaction to help separate the exchange from the refinance
3. **Refinance BEFORE Listing** - At a minimum, the Exchanger should attempt to complete the refinancing transaction prior to listing the relinquished property.
4. **Documentation** - The refinance loan and the sale or purchase price in the exchange should be documented as separate transactions to avoid any "interdependence" of the transaction.

Vacation Homes

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Can a Vacation home qualify as an “investment”

Reg. 1.1031(a)-1(b) states in the definition of "like-kind" that "unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale."

Safest way to proceed with a vacation home:

The property is treated as rental property if the owner's personal use is no more than 14 days or 10% of the rental days during the tax year and the property is rented more than 14 days during the tax year.

Related Parties

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Related Party Transactions

1. A related party can purchase the taxpayer's relinquished property. However, the related party must hold the relinquished property for at least two years or else the initial transaction is taxable in full.
2. A related party **CANNOT** sell the replacement property to the taxpayer. In the eyes of the service, this is the equivalent of cashing out.

Transfers Between Spouses

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- No gain or loss is recognized on a transfer of property from an individual to a spouse. If the transfer is incident to a divorce, no gain or loss is recognized on a transfer of property to a former spouse. There is no gain or loss even if the transfer is in exchange for the release of marital right or for other considerations or the transferred property is subject to liabilities that are more than the property's adjusted basis and it was not transferred in trust.
- Any transfer of property to a spouse or former spouse not subject to gain or loss is treated as a gift and is not considered a sale or exchange. There are no gift taxes if the transfer is made within a certain three-year period. This period starts two years before the divorce and ends one year after the divorce—a total of three years. If the transfer is made at any other time, it is subject to the gift tax. However a transfer under a property settlement agreed on before the divorce, and approved more than two years later by a divorce court, is subject to the gift tax.

Holding Requirements

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How Long Must an Investment Be Held???

- Neither the IRS nor the Regulations provide a comprehensive definition of “held for investment”.
- There is no safe period for property to automatically qualify.
- Time is only one factor that the IRS will look at to determine ‘intent’.

Guidance

- Private Letter Ruling stated that a min. holding period of 2 years is sufficient.
- > 12 months will reflect property as investment in two tax filing years.
- In 1998 Congress proposed a 1 year holding period (although it was never incorporated into the tax code).

Entity Issues

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Entity Issues

1. Title to the replacement property must be held in the same manner as title to the relinquished property
2. The entity beginning the exchange must be the entity concluding the exchange

Tax Filing

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1031 Tax Filing Requirements:

- **Form #8824, Like-Kind Exchanges**, is filed to reflect the exchange on the Exchanger's tax return in the year the transaction began
- **Form #4797 or Schedule D** is filed to report the taxable gain. The gain must be allocated between capital gain, ordinary income depreciation recapture, Section 1231 gain and unrecaptured Section 1250 gain.

Exchange Agents

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- **Understand the reasons why investors benefit from an Exchange.**
- **Learn how to locate potential investor clients.**
 - Network within your own sphere of influence (tax attorneys, lawyers, etc.).
 - Create a database of investors and keep in contact with them (North American Title may be able to provide access of current list of owners/investors).
 - Host investor “workshops”.
- **Communicate effectively with your clients.**
 - Ask the right questions.
 - Is the client aware of 1031?
 - Is the client reluctant to sell because of the tax consequences?
 - Provide marketing material about Section 1031.
- **Develop an effective Exchange Team.**
 - Attorney
 - CPA
 - Asset Exchange Company

Initiating an Exchange

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- **Discuss 1031 Exchanges with your tax and/or legal advisors.**
- **Call Asset Exchange Company with the following:**
 - Name, address and phone number of Exchangor.
 - The closer/escrow officer or closing attorney's name, address, telephone # and file #.
 - Your name, address and telephone #.
- **Ensure that the purchase and sale agreement is "assignable" and that the buyer is made aware of such assignment in writing.**
- **Include verbiage establishing the intent to perform a 1031 exchange in the Purchase and Sale Agreement. Example:**
 - *"Buyer is aware that Seller is to perform an IRC 1031 tax deferred exchange. Seller requests buyers cooperation in such an exchange, and agrees to hold Buyer harmless from any and all claims, liabilities, costs, or delays in time resulting from such an exchange. Buyer agrees to an assignment of this contract to Asset Exchange Company . by the Seller"*
- **Asset Exchange Company must execute exchange documents prior to close of sale.**

Why Asset Exchange Co?

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- Competitive Fees
- Attorney Guarantee
- Excellent Funds Security
- Substantial E&O Insurance and Fidelity Bond
- No Hidden Fees
- Proven Track Record
- Experience with all Exchange Types

Contact Info

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Asset Exchange Company

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